

1 UNITED STATES DISTRICT COURT

2 EASTERN DISTRICT OF WASHINGTON

3

4 UNITED STATES OF AMERICA,

5 Petitioner

6

7 No. CV-08-095-FVS

8 v.

9 JOHN J. SCHLABACH,

10 Respondent.

11

12 ORDER HOLDING JOHN  
13 SCHLABACH IN CONTEMPT OF  
14 COURT

15 **THIS MATTER** came before the Court on March 5, 2010, based upon  
16 the United States' objection to a recommendation submitted by  
17 Magistrate Judge Cynthia Imbrogno. The United States was represented  
18 by Michael J. Roessner. John J. Schlabach represented himself.

19 **BACKGROUND**

20 The Internal Revenue Service ("IRS") petitioned for an order  
21 requiring John J. Schlabach to comply with an IRS administrative  
22 summons.<sup>1</sup> Mr. Schlabach objected. In essence, there were two parts  
23 to his objection. For one thing, he argued the Court lacked authority  
24 to enter an order enforcing the summons. For another thing, he argued  
the IRS failed to satisfy the criteria for enforcement of a summons.  
*United States v. Powell*, 379 U.S. 48, 57-58, 85 S.Ct. 248, 13 L.Ed.2d  
112 (1964). On June 17, 2008, the Court overruled Mr. Schlabach's  
objections and ordered him to comply with the summons. He refused to

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26 <sup>1</sup>A copy is attached to the Declaration of Kate Lopez (Ct.  
Rec. 3) as Exhibit "A."

1 meet with an IRS agent. Consequently, the IRS filed a motion asking  
2 the Court to hold him in contempt. After the IRS filed the motion,  
3 but before the Court ruled, Mr. Schlabach agreed to meet with IRS  
4 Agent Kate Lopez. The meeting occurred on June 24, 2009. It lasted  
5 over three hours. Mr. Schlabach answered some questions, refused to  
6 answer other questions, and refused to provide financial records  
7 sought by the IRS. At least to some extent, he asserted his Fifth  
8 Amendment privilege against self-incrimination.

9 After the June 24th meeting, Mr. Schlabach advised the Court he  
10 had complied with the summons. He urged the Court to deny the IRS'  
11 contempt motion. The IRS disagreed with his assessment of the  
12 meeting. In its opinion, he wrongfully refused to provide non-  
13 privileged information that is covered by the summons. Thus,  
14 according to the IRS, he remains in violation of the Court's order of  
June 17, 2008.

15 The Court referred the dispute to Magistrate Judge Imbrogno for a  
16 report and recommendation. One of her tasks was to determine whether  
17 the IRS is seeking information from Mr. Schlabach that is protected by  
18 the Fifth Amendment privilege against self-incrimination. This meant  
19 giving him an opportunity to respond to the IRS' questions on the  
20 record:

21 Only after an invocation of the privilege with respect to a  
22 specific question can a reviewing court determine whether a  
23 responsive answer might lead to injurious disclosures.

24 [United States v. Pierce, 561 F.2d 735, 741 (9th Cir.1977)];  
see also United States v. Bell, 448 F.2d 40, 42 (9th  
25 Cir.1971). Thus, "[t]he only way the Fifth Amendment can be  
26 asserted as to testimony is on a question-by-question  
basis." United States v. Bodwell, 66 F.3d 1000, 1001 (9th  
Cir.1995). A taxpayer must "present himself for

1 questioning, and as to each question elect to raise or not  
 2 to raise the defense. The District Court may then determine  
 3 by considering each question whether, in each instance, the  
 4 claim of self-incrimination is well-founded." *Bell*, 448  
 5 F.2d at 42.

6 *United States v. Drollinger*, 80 F.3d 389, 392 (9th Cir.1996).

7 Magistrate Judge Imbrogno conducted a hearing on January 28, 2010.  
 8 During the first phase of the hearing, counsel for the IRS examined  
 9 Mr. Schlabach. She asked over 100 questions. He provided substantive  
 10 answers to very few of them. Instead, he repeatedly asserted his  
 11 Fifth Amendment privilege against self-incrimination. During the  
 12 second phase of the hearing, Magistrate Judge Imbrogno met with Mr.  
 13 Schlabach *in camera* and gave him an opportunity to explain his  
 14 position more fully. The record of their *in camera* discussion is  
 15 sealed. After the January 28th hearing, Magistrate Judge submitted a  
 16 report. She recommends the Court deny the IRS' motion to hold Mr.  
 17 Schlabach in contempt. The IRS objects.

18 On March 5, 2010, the Court held a hearing regarding the IRS'  
 19 objections. The hearing proceeded in phases. The first phase was a  
 20 public phase, during which the parties set forth their competing  
 21 positions. After they had done so, the Court excused counsel for the  
 22 IRS and allowed Mr. Schlabach to explain, *in camera* and on the record,  
 23 why he fears prosecution if he answers the IRS' questions and provides  
 24 the documents it requests. The record of the *in camera* phase of the  
 25 hearing is sealed.

**STANDARD**

26 The IRS bears the burden of proving Mr. Schlabach is in contempt.

*United States v. Bright*, No. 07-17027, 2010 WL 669260, at \*6 (9th Cir.  
 27 Feb. 26, 2010). The IRS must show by clear and convincing evidence he

1 violated the Court's order of June 17, 2008. *Stone v. San Francisco*,  
2 968 F.2d 850, 856 n.9 (9th Cir.1992). If the IRS makes such a  
3 showing, the burden shifts to Mr. Schlabach to show why he was unable  
4 to comply. See *id.* This does not mean he has an opportunity to  
5 relitigate the validity of the order. See *United States v. Rylander*,  
6 460 U.S. 752, 756-57, 103 S.Ct. 1548, 75 L.Ed.2d 521 (1983) (citations  
7 omitted). To the contrary, he is bound by its terms. See *id.* He  
8 must show he performed every reasonable act within his power that was  
9 necessary to insure compliance. *Stone*, 968 F.2d at 856 and n.9.

10 **RULING**

11 As explained above, the Court entered an order on June 17, 2008,  
12 enforcing the summons the IRS served upon Mr. Schlabach. Despite the  
13 order, he has not provided any records to the IRS. Furthermore, at  
14 the hearing on January 28, 2010, he provided substantive answers to  
15 very few of the questions posed by the IRS' attorney. In view of the  
16 preceding circumstances, the IRS has made a *prima facie* showing he is  
17 in violation of the enforcement order. Thus, it is his responsibility  
18 to justify his conduct by demonstrating he has taken every reasonable  
19 step that is necessary to comply. In that regard, he makes  
20 essentially three arguments: the IRS has abandoned most of the  
21 requests for information that are set forth in the summons; he would  
22 incriminate himself if he provides the information requested by the  
23 IRS; and he is presently unable to produce some of the documents  
sought by the IRS.

24 A. Abandonment

25 Mr. Schlabach cites the "United States' Memorandum in Opposition  
26 to Respondent's Renewed Rule 11 Motion" (Ct. Rec. 92) for the  
proposition that the IRS has abandoned most of the requests for

1 information that are contained in the summons. According to Mr.  
 2 Schlabach, only three requests remained as of January 28th: one was  
 3 for his bank records; a second was for a list of his past and present  
 4 employers; and a third was for documents he allegedly provided to an  
 5 attorney. He maintains the purpose of the January 28th hearing was to  
 6 determine whether he has supplied the three categories of information  
 7 described above. Instead of focusing on those categories, says Mr.  
 8 Schlabach, counsel for the IRS questioned him about different  
 9 categories of information. He maintains the subjects about which he  
 10 was questioned at the January 28th hearing are not relevant with  
 11 respect to whether he has complied with the IRS' summons. Mr.  
 12 Schlabach is mistaken. None of the IRS' memoranda indicate the IRS  
 13 has intentionally relinquished any of the requests that are contained  
 14 in the summons. Thus, Mr. Schlabach must disclose all of the  
 15 information listed in the summons unless he is presently unable to  
 16 provide it or he is entitled to assert his Fifth Amendment privilege  
 17 against self-incrimination. See *Rylander*, 460 U.S. at 757, 103 S.Ct.  
 18 1548 (present inability); *Drollinger*, 80 F.3d at 392-93 (privilege).

19 B. Privilege

20 1. waiver

21 The threshold issue is whether Mr. Schlabach waived his privilege  
 22 against self incrimination by failing to assert it prior to the date  
 23 upon which the Court entered the enforcement order. Cf. *Rylander*, 460  
 24 U.S. at 757, 103 S.Ct. 1548 ("a contempt proceeding does not open to  
 25 reconsideration the legal or factual basis of the order alleged to  
 26 have been disobeyed" (quoting *Maggio v. Zeitz*, 333 U.S. 56, 69, 68  
 S.Ct. 401, 92 L.Ed. 476 (1948)); *Bright*, 2010 WL 669260, at \*6 ("When  
 defending against a finding of contempt after an adversary enforcement

1 proceeding, a taxpayer cannot relitigate the Fifth Amendment privilege  
 2 or lack of custody or control."). Although Mr. Schlabach did not  
 3 assert the privilege before the enforcement order was entered, he did  
 4 assert it during his meeting with Agent Lopez on June 24, 2009. Their  
 5 meeting was the first time he was questioned by an IRS agent pursuant  
 6 to the summons. Since he asserted the privilege when he was first  
 7 questioned, he may assert it now. See *Drollinger*, 80 F.3d at 392  
 8 ("Because Drollinger did not have an earlier opportunity to answer  
 9 specific questions, he was entitled to raise and litigate his Fifth  
 10 Amendment claim when those questions were finally asked during the  
 11 purgation proceedings.").

12       2. *refusing to answer questions at the hearing*

13       Mr. Schlabach argues virtually all of the questions posed at the  
 14 January 28th hearing sought privileged information. Nevertheless, he  
 15 is particularly concerned about questions 26, 29, 55, 56, 74, and 80.  
 16 (Respondent's Reply at 5.) He appears to be referring to the list of  
 17 questions contained on pages 5-8 of the United States' Objection (Ct.  
 18 Rec. 102). However, there is a problem: The list in the IRS'  
 19 memorandum does not correspond exactly with the questions that were  
 20 posed during the January 28th hearing. For example, the United  
 21 States' Objection states in part:

22       25. Were you the trustee any [sic] of the [Capital  
 23 Holdings'] trusts?

24       26. Did you report the earning from those trusts on your tax  
 25 return?

26       (United States' Objection (Ct. Rec. 102) at 6.) The actual exchange  
 27 between the IRS's attorney and Mr. Schlabach was as follows:

28       Ms. McCormally: "Sir, we believe that you were the trustee  
 29 for a number of trusts for Capital Holdings . . . . So, my

1 question is: Were you a trustee on any of those trusts?"

2 . . . .  
3 Mr. Schlabach: I'm going to assert my right to remain  
silent.

4 . . . .  
5 Ms. McCormally: Did you report earnings from trusts that  
6 you created or held in the Capital Holdings environment or  
7 business on your tax return? Did you report earnings from  
those trusts on your tax return?

8 Mr. Schlabach: I'm going to invoke my right to remain  
silent.

9 (Transcript of January 28, 2010, hearing (Ct. Rec. 94) at 23-24.)

10 In order to understand the dispute between the parties, one must  
11 understand what they mean by "Capital Holdings." It is an indirect  
12 reference to events that gave rise, some years ago, to a federal  
13 prosecution in the District of Colorado. The indictment was filed  
14 during 2004 or 2005. It charged a number of individuals, but not Mr.  
15 Schlabach, with the crimes of mail fraud, wire fraud, and securities  
16 fraud in connection with an investment scheme. Mr. Schlabach was  
17 aware of the "Capital Holdings" case as it unfolded; and it was while  
18 the case was unfolding that Agent Lopez served him with the summons at  
issue here.

19 As the above-quoted exchange indicates, the IRS wants to probe  
20 Mr. Schlabach's involvement in "trusts" that were associated with the  
21 Capital Holdings case. But that's not the only activity the IRS is  
22 concerned about. The IRS also wants to probe his involvement, if any,  
23 in a tax shelter that the parties refer to as an "Unincorporated  
24 Business Organization Trust" or "UBO":

25 Ms. McCormally: During what years did you prepare UBOs?

26 Mr. Schlabach: I don't prepare UBOs. Never have. What's a  
UBO?  
. . . .

1 Ms. McCormally: During what time period were you involved  
2 in any way with UBOs?

3 Mr. Schlabach: . . . "I'm going to invoke my right to  
4 remain silent, and I'll offer -- provide my offer of proof  
5 in camera, your Honor.

6 (Transcript of January 28th hearing at 13-14.)

7 Mr. Schlabach genuinely fears the IRS is using the summons to  
8 obtain information that will serve as the basis of a criminal  
9 prosecution: perhaps a spin-off of the Capital Holdings case; perhaps  
10 something else. He may be correct; but the fact the IRS suspects a  
11 taxpayer engaged in criminal activity does not necessarily prevent the  
12 IRS from issuing an administrative summons in order to investigate its  
13 suspicions. To the contrary, the "'IRS may issue a summons for a  
14 solely criminal purpose as long as the case has not been referred to  
15 the Department of Justice for criminal prosecution or grand jury  
16 investigation.'" *United States v. Norwood*, 420 F.3d 888, 894 (8th  
17 Cir.2005) (quoting *United States v. Claes*, 747 F.2d 491, 496 (8th  
18 Cir.1984)). Nevertheless, while an IRS agent may serve a summons and  
19 seek its enforcement, the summons may refuse to provide information  
20 if doing so would infringe his Fifth Amendment right against self-  
21 incrimination. See, e.g., *United States v. Lawn Builders of New*  
22 *England, Inc.*, 856 F.2d 388, 393 (1st Cir.1988) ("a valid invocation  
23 of a Fifth Amendment privilege may relieve the summons from answering  
24 questions"). However, the summons must demonstrate the disputed  
25 information is privileged. The issue is whether "there are  
26 substantial hazards of self-incrimination that are real and  
appreciable, not merely imaginary and unsubstantial, that information  
sought in an IRS summons might be used to establish criminal  
liability." *Bright*, 2010 WL 669260, at \*3 (internal punctuation and

1 citations omitted).

2 The IRS contends Mr. Schlabach's fear of prosecution is too  
3 conjectural to justify his refusal to answer the questions posed to  
4 him during the January 28th hearing. In support of its contention,  
5 the IRS has submitted a letter from an Assistant United States  
6 Attorney indicating the Capital Holdings case is closed except for  
7 appeals and collateral attacks, and his office "is not participating  
8 in any ongoing investigation related to this case." (Letter of  
9 Matthew T. Kirsch dated February 11, 2010, at 1.) In addition, the  
10 IRS points out the statue of limitations for non-capital federal  
11 crimes is five years. 18 U.S.C. § 3282(a). The Capital Holdings  
12 defendants were first indicted during 2004 or 2005. The IRS argues  
13 the statute of limitations has expired with respect to any acts Mr.  
14 Schlabach may have committed in connection with that case; which is  
15 significant because "the Fifth Amendment's privilege against self-  
16 incrimination does not apply after the relevant limitations period has  
17 expired." *Stogner v. California*, 539 U.S. 607, 620, 123 S.Ct. 2446,  
18 156 L.Ed.2d 544 (2003) (citing *Brown v. Walker*, 161 U.S. 591, 597-98,  
16 S.Ct. 644, 40 L.Ed. 819 (1896)).

19 The questions the IRS' attorney asked at the January 28th hearing  
20 are a matter of record. It was those questions Mr. Schlabach had to  
21 evaluate as they were asked. The IRS' attorney had great latitude in  
22 deciding what questions to ask Mr. Schlabach. She could have limited  
23 her questions to events for which the statute of limitations has  
24 expired. She did not always do so. Mr. Schlabach reasonably could  
25 have feared that if he fully answered her questions concerning the  
26 Capital Holdings case and UBOs, he would "'furnish a link in the chain  
of evidence needed to prosecute [him] for a federal crime.'" *United*

1       *States v. Rendahl*, 746 F.2d 553, 555 (9th Cir.1984) (quoting *Hoffman*  
2       *v. United States*, 341 U.S. 479, 486, 71 S.Ct. 814, 95 L.Ed. 1118  
3       (1951)). As a result, he was not required to answer the questions she  
4       asked about those two subjects. Questions about other subjects are a  
5       different matter. For example, the IRS' attorney attempted to  
6       ascertain Mr. Schlabach's employment history. He refused to answer  
7       her questions. (Transcript of January 28th hearing at 11-13.) His  
8       refusal to answer employment-related questions was unjustified because  
9       he has failed to demonstrate the information she sought was  
10       incriminating. The same is true of a number of his other refusals to  
11       answer questions. He should have answered, to the best of his  
12       ability, those questions that correspond to questions 1-3, 7-9, 17-19,  
13       28, 33-39, 77, and 79 in the list set forth in the United States'  
14       Objection.

15                   3. financial records

16       The IRS seeks Mr. Schlabach's financial records from January 1,  
17       2001, to the present. A request for production of records may raise  
18       two analytically distinct Fifth Amendment issues. One is whether the  
19       act of producing the records is incriminating. Another is whether the  
20       contents of the records are incriminating. *United States v. Hubbell*,  
21       530 U.S. 27, 36-7, 120 S.Ct. 2037, 147 L.Ed.2d 24 (2000). Mr.  
22       Schlabach does not claim the act of producing his financial records is  
23       incriminating. Rather, he focuses upon the contents of his financial  
24       records. The Court has reviewed the documents Mr. Schlabach submitted  
25       for *in camera* review. No doubt he is sincerely reluctant to disclose  
26       the documents he submitted. Be that as it may, any link between the  
records he submitted and criminal prosecution is too attenuated to  
justify his invocation of the privilege against self-incrimination.

1        C. Present Inability

2        The IRS wants Mr. Schlabach to disclose any records he has  
3 pertaining to Unincorporated Business Organization Trusts. Mr.  
4 Schlabach claims he did not prepare UBOs and, thus, he has no records  
5 pertaining to UBOs. (Respondent's Reply at 5.) In other words, he  
6 claims he has a present inability to provide some of the records the  
7 IRS seeks. *Bright*, 2010 WL 669260, at \*7 ("Once the government has  
8 established a *prima facie* case of contempt, a taxpayer may avoid  
9 sanctions by demonstrating a present inability to comply with the  
10 enforcement order." (citing *Drollinger*, 80 F.3d at 393)). The IRS is  
11 not required to accept his assertions at face value. After all, he  
12 admits he destroyed records. (Respondent's Reply (Ct. Rec. 106) at  
13 4.) Indeed, the IRS had an opportunity at the January 28th hearing to  
14 test his assertions by asking questions that did not seek privileged  
15 information, *i.e.*, questions that focused on activities that are now  
16 outside the statute of limitations. The IRS did not avail itself of  
the opportunity.

17        **IT IS HEREBY ORDERED:**

18        The "United States' Motion to Hold John J. Schlabach in Contempt"  
19 (**Ct. Rec. 50**) is granted in part. Within 20 days of entry of this  
20 order, he shall appear before an IRS agent and

21        1. answer questions 1-3, 7-9, 17-19, 28, 33-39, 77, and 79 in the  
22 list set forth in the United States' Objection; and

23        2. provide copies of those of his bank records that are covered  
24 by the IRS' administrative summons.

25        **IT IS SO ORDERED.** The District Court Executive is hereby  
26 directed to enter this order and furnish copies to Mr. Schlabach and

1 to counsel for the United States.

2 **DATED** this 24th day of March, 2010.

3 s/ Fred Van Sickle  
4 Fred Van Sickle  
5 Senior United States District Judge  
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